

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter. of the Appeal of)
PFIZER INC., FORMERLY CHAS.)
PFIZER & CO., INC.)

Appearances:

For Appellant: Stanley B. Dessen
Tax Manager

For Respondent: Jack E. Gordon
Supervising Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Pfizer Inc., formerly Chas. Pfizer & Co., Inc., against proposed assessments of additional franchise tax in the amounts of \$7,160.75, \$22,854.78, \$17,999.94, \$36,303.83, and \$93,702.37 for the income years 1959, 1960, 1961, 1962, and 1963, respectively.

As originally filed, this appeal involved two issues: (1) whether appellant was engaged in a unitary business with its wholly-owned Panamanian subsidiary, Pfizer Corporation, and (2) whether 100 percent of California destination sales of appellant's two ethical pharmaceutical divisions, Pfizer Laboratories and Roerig, should be included in the numerator of the sales factor

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of the apportionment formula in determining appellant's California franchise tax liability. Subsequently respondent withdrew those portions of the assessments arising from its termination that appellant and its Panamanian subsidiary were unitary. Respondent also conceded that some 5 percent of appellant's California destination sales, primarily to agencies of the United States Government, were properly excluded from the numerator of the sales factor because they were negotiated entirely at appellant's headquarters in New York. As a result of these modifications the assessment proposed for income year 1959 was eliminated and the assessment for each of the other years was reduced. The proposed assessments for income years 1962 and 1963 were further revised in accordance with certain federal adjustments.

Appellant is in agreement with all of the above adjustments. The sole issue remaining for decision, therefore, is whether all of the California destination sales of appellant's ethical pharmaceutical divisions, exclusive of those sales conceded to have been negotiated in New York, should be included in the 'numerator' of the sales factor.

Appellant is a New York corporation which has done business in California since 1946. Its business includes the manufacture and sale of ethical pharmaceutical drugs, and a portion of its gross receipts from such drug sales is derived from sources within this state. During the years in question appellant had sales offices and a warehouse and distribution center in this state. It also maintained a staff of professional service representatives, or "detailmen." - Their primary function was to contact doctors and to acquaint them with appellant's products, to describe the qualities of those products, and generally to create a favorable disposition toward them. It was hoped that such "detailing" would result in the prescribing of appellant's drugs, rather than those of competitors, in appropriate situations. A smaller portion of the detailmen's time was spent in hospitals, both gathering and imparting information, and in contacting pharmacies in order to insure an adequate supply of appellant's products.

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Since appellant's income was derived from sources both within and without this state, its tax is measured by the net income derived from sources within this state. (Rev. & Tax. Code, § 25101.) Section 25101 requires income to be apportioned by formula, and respondent's regulation generally prescribes the use of a three-factor formula consisting of property, payroll, and sales. (Cal. Admin. Code, tit. 18, reg. 25101.) With respect to the sales factor, the cited regulation states:

The sales or gross receipts factor generally shall be apportioned in accordance with employee sales activity of the taxpayer within and without the State. This factor is computed on the basis of gross sales or receipts, less returns and allowances. The same rule applies to repeat or mail order sales resulting from prior employee solicitation. Sales which are made through brokers or factors shall be explained in detail in schedules attached to the return. Promotional activities of an employee are given some weight in the sales factor.

It is respondent's contention that the activities of appellant's detailmen are essentially equivalent to the employee sales activity referred to in the above regulation. In support of this position respondent describes the unique nature of the ethical drug industry, i.e., drug sales are not made as the result of a sales campaign directed at the ultimate consumers of such products, as is usually the case, but are the result of prescriptions made by physicians. According to respondent the activities of the detailmen, directed as they are at physicians, are responsible for the eventual sales of drugs and must, therefore, be regarded as the employee sales activity contemplated by the regulation. (See Commonwealth v. Eli Lilly and Co., 439 Fa. 268 [266 A.2d 636].)

Appellant takes the contrary position that the phrase "employee sales activity" as it is used in regulation 25101 refers primarily to solicitation activities. (Appeal of Pratt & Whitney Co., Inc., Cal. St. Bd. of Equal., May 24, 1961.) Appellant urges that the acti-

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vities of its detailmen are essentially promotional in nature, rather than solicitational, since the detailmen do not engage in any direct solicitation of prescription drug sales, and such activities are therefore not within the scope of "employee sales activity" as that phrase is used in regulation 25101. Appellant then focuses on the last sentence of that regulation, which states that employee promotional activities are given some weight in the sales factor, and concludes that its inclusion in the numerator of the sales factor of 25 percent of its California destination sales more accurately corresponds with the concept of "some weight" than respondent's inclusion of 100 percent (less sales concededly negotiated in New York).

We do not believe that our decision in Appeal of Pratt & Whitney Co., Inc., supra, can be construed to mean that the "employee sales activity" referred to in regulation 25101 always means solicitation activities. In that case we were dealing with a situation in which there was direct solicitation of sales in California by the appellant's employees, unlike the instant case. Our holding there turned on our determination that the sales factor should not include values already reflected in the property and payroll factors. Furthermore, in Appeal of Avco Manufacturing Corp., Cal. St. Bd. of Equal., Dec. 16, 1959, the employee activity in question was of a promotional nature, with no solicitation of purchase orders, yet it was still treated as "sales activity."

Nor do we view our decision in Appeal of Smith, Kline & French Laboratories, Cal. St. Bd. of Equal., April 20, 1960, as establishing that the work of detailmen is merely "promotional" within the meaning of regulation 25101. In that case we were concerned with the constitutionality of imposing the California corporation income tax on the appellant, not with the question of whether the proper values had been included in the sales factor. Our recognition of the nature and import of the activities of those employees was apparent in our observation that:

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. . . the activities which they [the professional service representatives, or detailmen] engaged in, promoting Appellant's products among the doctors who prescribed drugs for their patients, went to the heart of the matter of selling drugs in this State....

The purpose of the sales factor is to serve as a balance against the property and payroll factors and "sales should, so far as possible, be apportioned to the state where the markets are found, from which the business is received, or where the customers are located." (Altman and Keesling, Allocation of Income in State Taxation (2d ed. 1950) pp. 126, 128; Appeal of Fourco Glass Co., Cal. St. Bd. of Equal., April 20, 1960; Appeal of Avco Manufacturing Corp., supra. Sales activity in any business is directed at those who have the power to cause a sales transaction to occur. Normally the person with that power and the ultimate consumer are one and the same. In the instant case, however, the ultimate consumer cannot effect a drug sales transaction. That power resides in the prescribing physician, and that is where appellant has directed its sales campaign. It is the direct contact of the detailmen with California physicians which results in the sales of drugs in this state. We believe that those activities must be regarded as "employee sales activity" within the meaning of regulation 25101.

In support of its contention that substantially less than 100 percent of its California destination ethical drug sales should be included in the numerator of the sales factor, appellant has submitted detailed schedules containing a summary of expenses incurred by its pharmaceutical divisions. Appellant has divided those expenditures into what it considers to be "detailing expenses," on the one hand, and "advertisement and promotional expenses" on the other. Appellant offers these documents as proof that a substantial amount of "employee sales activity" connected with its ethical drug sales in California took place at its headquarters in New York. The activity in New York consisted primarily of advertising, Preparation of literature on appellant's ethical drugs, and

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preparation of sample drugs for distribution by direct mail and by the detailmen.

In order to give effect to the purpose of the sales factor, the selling activities which are taken into consideration must be a relatively restricted group of activities. It would be impossible to include every act which might conceivably influence the making of a sale. We believe that with present sales approaches in the ethical drug industry, the employee sales activity which should be included in the sales factor is the direct, person-to-person contact of the detailmen with the physicians who ultimately prescribe the drugs.

Upon careful consideration of the entire record we must therefore conclude that in this particular case respondent has properly treated the activities of appellant's detailmen as the "employee sales activity" contemplated by regulation 25101. That being so, we believe respondent has acted within its discretion in including all of the California destination sales of appellant's ethical pharmaceutical divisions, exclusive of those concededly negotiated in New York, in the numerator of the sales formula of the apportionment formula used in determining appellant's California franchise tax liability.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the protest of Pfizer Inc., formerly Chas. Pfizer & Co., Inc., against proposed assessments of additional franchise tax in the amounts of \$7,160.75, \$22,854.78, \$17,999.94, \$36,303.83, and \$93,702.37 for the income years 1959, 1960, 1961, 1962, and 1963, respectively, be and the same is hereby modified to eliminate the assessment for the income year 1959 and to reduce the assessments for the remaining income years in accordance with the revised assessments submitted by the Franchise Tax Board. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 8th day of May, 1973, by the State Board of Equalization.

William G. Bunker, Chairman
Robert K. Kegan, Member
John W. Lynch, Member
Robert L. Allen, Member
_____, Member

ATTEST:

W. W. Dunlop, Secretary